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THE GOODS AND SERVICES TAX: COMMENTS ON THE TECHNICAL PAPER

Marion Wrobel
ECONOMICS DIVISION

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INTRODUCTION

In 1991, if all goes as planned by the federal government, Canadians will pay a new tax whenever they make purchases from a wide range of goods and services. This new sales tax will, for most Canadians, be applied in addition to the existing retail sales taxes with which they are now familiar.

The proposed goods and services tax (GST) will also be a new experience for businesses. Today, some of these collect and remit retail sales taxes, while those which produce or import manufactured goods collect and remit the federal manufacturers' sales tax (MST). There are still, however, numerous enterprises which never see the current taxes directly because they neither sell nor buy taxed products at the retail level, nor do they produce or import manufactured goods.

The new GST would be a multi-stage sales tax. One obvious result of its introduction would be to increase vastly the number of taxpayers. Tax liabilities would be incurred at every stage in the production process and, with some exceptions to be discussed later, by every person or every firm engaging in production or sale of goods and services.

This tax would, then, dramatically affect the way in which sales tax revenue is collected at the federal level, significantly broadening the base, altering the rate and consequently changing the relative amount of sales tax inherent in the prices of various products. By taxing services and other non-manufactured goods directly, substantial shifts in relative prices would take place. This tax would also dramatically increase the amount of sales tax revenue collected by the

federal government, but numerous mechanisms are proposed to return part of these revenues to the taxpaying public.

This paper will examine a number of issues related to the GST, as described in the technical paper released by the Minister of Finance in August 1989. The discussion will cover the impact of a number of items which the Department of Finance considers resolved at this time, as well as of a number of items for which no resolution yet exists.

GST REVENUES

A. Fiscal Consequences

The GST, as outlined in the August technical paper, is predicted to generate $24 billion in 1991, this amount being based on a rate of 9%. Of this total revenue, about $18.5 billion would replace the revenue lost by the elimination of the existing MST, which by 1991 would have been levied at a rate of 13.5% for most products. The remaining $5.5 billion would be returned to taxpayers in one form or another. By far the most important element in this regard would be the greatly enhanced sales tax credits. Such refundable credits have been used for a number of years by the federal government to alleviate the impact of the MST on lower-income families. The existing system of credits would have cost $1.2 billion in 1991. The proposed credits would cost about $3.6 billion. The difference ($2.4 billion) would be financed by GST revenues.

The middle income tax rate, which currently stands at 26%, would be reduced to 25%, a move which would cost the federal government about $700 million. Since most provincial taxes are levied on top of the federal one, this move would equal to a total marginal reduction of about 1.5 percentage points if the provinces did not alter their income tax systems in the wake of this rate change.

Finally, about $2 billion in revenues would be transferred to individuals and provinces as a result of the GST's impact on the price level. The personal income tax system (PIT) is indexed to inflation, as are various transfers to the provinces and Old Age Security and Family

Allowance payments. The introduction of the GST is expected to raise prices by about 2.25%, subsequently lowering tax revenues and raising government expenditures as indexing provisions came into play.

OAS payments are fully indexed. PIT and Family Allowance are only fully indexed to inflation in excess of 3% per year. If the rate of inflation in the absence of this tax was expected to be over 3%, any marginal increase due to the introduction of the GST would be fully indexed.

The remaining $200 million in GST revenues is slated to pay for additional administrative costs which, according to some estimates, could include the hiring of up to 4,000 additional employees to handle the tax. The government has provided no definitive estimate of administrative costs.

B. Revenue Neutrality?

The fiscal consequences of this new tax have been the subject of much debate. The $24 billion in anticipated GST revenues would not provide the government with any new sources of funds to fight the deficit. The new tax would replace an existing tax and transfer funds to individuals directly and indirectly through the provinces. In this sense one might claim that the reform measures would in fact, be revenue neutral.

One can also argue the contrary. When sales tax reform proposals were first announced in 1986, the MST was raising revenues of about $13 billion. Since then, the MST rate has been raised significantly to the point where it now stands at 13.5% for most goods and is expected to raise over $18 billion in 1991. Had the reform package itself, rather than previous budgets, increased sales tax revenues from $13 billion to over $18 billion, no-one would be arguing that the tax was neutral.

The argument against revenue neutrality is further strengthened by noting that the federal government, in proposing a reform of the sales tax, has recognized the serious problem associated with the erosion of the MST base. The 13.5% MST rate might well be viewed as untenable over time. Rather, it is only a temporary measure until such

time as the GST can be put in place. In other words, the GST might be able to deliver $18.5 billion in net revenues, but the MST would never have been able to do so. Thus when the government raised the MST rate in the 1989 budget to generate funds to reduce the deficit, it might well have been doing so in preparation for introducing a GST.

Furthermore, the impact on the deficit should not be viewed as the sole test of neutrality. If the added revenues were slated to pay for new programs such as a national daycare program, no one would claim that the system was revenue neutral, even though tax revenues would be, in a sense, returned to Canadians. We would recognize that tax reform was being used to fund a new program. Why can we not view the system of tax credits in the same way? It clearly alters the distribution of income. How does this system of credits differ from any other form of targeted public assistance? Tax expenditures are increasingly being substituted for program expenditures and loose interpretation of the concept of revenue neutrality allows tax based measures to be unnoticed in a way that expenditure measures could not be.

By stressing the alleged revenue neutrality in the tax reform, the government is pointing out that there are structural problems inherent in our present tax system which need to be addressed for their own sake. Determining the appropriate level of taxes and expenditures is a task which the government faces whether or not it reforms the tax system. These are two distinct issues which should not be confused.

THE ENHANCED GST CREDITS

In the 1989 federal budget, the Minister of Finance raised the refundable sales tax credit to a maximum of $140 per adult and $70 per child, subject to a 5% reduction for family income in excess of $18,000. This credit, like the refundable child tax credit has a very simple design. If family income is below the turning point of $18,000, full credits are received. Beyond the turning point, credits decline at a constant rate until they reach zero. Total credits increase as family size increases.

Under the GST, the turning point would be raised to $24,800 and the credits would be substantially enhanced. The system would, however, be more complicated. The maximum credit would be $275 per adult and $100 per child. In a single parent family, an adult credit, rather than the child credit, could be received with respect to one child. Such a feature does not exist under the present sales tax credit system but it does exist in the income tax system; a single parent can claim a non-refundable "equivalent to married" credit for one child, rather than the usual dependant credit.

This new credit regime has another component. The technical paper argues that there are additional costs for those who maintain a single-person household. As a consequence a single person's credit would be available. This credit would be calculated as 2% of net income in excess of $6,175, to a maximum of $140. This maximum would be granted at a net income level of $13,175 and more. It would be available to all single adults, even those with children, and would be included in the total GST credits which would be subject to the reduction rate of 5% once income exceeded the turning point.

There are a number of potential difficulties associated with these credits. In the first place they would complicate the calculation of benefits. A taxfiler would have to calculate his or her net income in excess of $6,175 and then determine 2% of this, and enter that amount, or $140, whichever was less, on the appropriate line of the tax form. The taxpayer would then have to determine the extent to which the benefit would be reduced by comparing income to the turning point of $24,800. Part of this procedure will be familiar to taxpayers who have previously claimed the refundable CTC or STC. Under the proposed system, however, credit would actually increase with income over some range. In addition, one measure of income (net income as calculated on a tax form) would be used to determine the level of the single person's credit, while another measure of income (net income plus social assistance benefits, worker's compensation and guaranteed income supplement) would be used to determine the amount of total credit reduction.

The technical paper offers a weak rationale for the single person's credit. Its intention is to recognize the fact that maintaining a

household involves some fixed expense, regardless of family size. Since there are economies of scale in maintaining a household, a case might be made for a special single credit. Married couples would not get such a credit, possibly because they would receive two adult credits, whereas a single person would get only one. If this is the reason, however, it seems odd to extend this credit to a single parent since such a family configuration would also have access to two adult credits, the parent's and that allowed for one child.

The size of the single credit would be such that total credits could actually decline as family size increased. For example, a three-person family (one parent, two children) could receive more than a four-person family (two parents, two children) earning the same amount of income (see Figure 1). It is difficult to see how a three-person family can be assumed to have a higher cost of living than a four-person family. The technical paper neither recognizes this anomaly, nor does it explain this departure from the concept of horizontal equity always implicit in past credit schemes.

In another potential anomaly in the GST credit, the technical paper states that "both the equivalent-to-married and the additional $140 credit will be subject to restrictions analogous to those in the Income Tax Act so that, to the extent possible, married and common-law couples will receive the same credit benefits." The Income Tax Act does not recognize common-law marriages. Common-law spouses are treated as single individuals. It is only when two unmarried adults have children together that the Act treats them as a family unit.

It is possible that the credit system would greatly favour common-law couples. There are several reasons for this. Unmarried adults would be treated as single and therefore eligible for the single's credit. If they had children, one child would be eligible for an adult credit rather than a child credit. The benefit reduction for such a couple would be calculated on the basis of individual rather than joint income, unless both adults were the parents of the child. Until proposed legislation is made public, it is not known just how this credit would actually work. Existing legislation can, however, give some indication of possible rules.

Consider the case of two adults living together as a family. If the couple was married, they would be entitled to a maximum GST credit of $550, which would be reduced on the basis of family income. If the couple were unmarried, each individual would be entitled to an adult credit, reduced on the basis of individual income. Rather than having the credits start to diminish at $24,800 of total income as in the case of a married couple, the credits might not start to diminish until total income reached $49,600 if both adults earned the same amount.

In addition, the unmarried couple would be treated as two single individuals. At first glance it seems that both individuals would be eligible for a single's credit. In testimony before the House of Commons Standing Committee on Finance and Economic Affairs on 15 August 1989, the Deputy Minister of Finance stated that an unsupported individual filing an income tax return would be considered a separate household, even if sharing accommodation with others, such as parents. If this statement is accurate, then two unmarried adults living together would then be treated as two households if they both filed returns. The common law couple would then be entitled to two single's credits. Figure 2 presents the different levels of benefits available to a married and unmarried couple. At an income level which would cut the married couple off GST credits, the unmarried couple could still be receiving over $800 in credits.

Consider the case of married and unmarried couples with children. Married parents could claim a maximum of $100 per child but single parents could claim up to $275 for one child. In addition, unmarried parents would also be eligible for the single's credit.

The Income Tax Act requires that a common law couple report their joint income when claiming a child tax credit or sales tax credit with respect to a child, of whom they are both the parents. If only one is a parent of the child, then the couple does not report joint income. Under GST, a two-adult, one-child family could claim a maximum credit of $650 if married and $1,105 if unmarried (three adult credits plus two single's credits). The married couple would cease receiving any credits once family income reached $37,800 whereas the unmarried couple could still be

receiving maximum benefits at such a point. This situation is portrayed in Figure 3.

The <u>Income Tax Act</u> allows single parents to claim an "equivalent to married" credit for one child. Only one such credit can be claimed for each domestic establishment. If this rule was applied to the GST credit, a two-adult, two-child common law unit, with neither child being the offspring of both adults, would be eligible for three adult credits and one child credit rather than four adult credits. The adults would have to decide among themselves who claimed the extra adult credit.

This rule might also be applied to the single's credit so that only one single's credit would be allowed per domestic establishment. This would differ from the notion of "household" as used by the Deputy Minister of Finance and would reduce the bias of the GST credit against married couples. But it would not eliminate that bias, which could, in some circumstances, still be significant.

IMPACT ON HOUSING

Undoubtedly, housing accounts for the single largest expenditure made by families. This is true whether they own or rent. The tax treatment of this sector is then very important to personal finances. This section will examine the possible effect of the GST on housing markets by considering its implications for new construction, the rental market, the resale market, etc. Since land would be effectively taxed by the GST in some circumstances, we will also consider any potential relative price effects.

A. New Owner-Occupied Housing

The 1989 budget increased the MST on building materials to 9%. The 13.5% rate applies to other manufactured goods which go into the construction of the house. Land is not taxed, nor are labour services and builder's profits. By 1991, this MST should be equivalent to a 4% rate on

the price of an average new house. Where land is relatively expensive, the effective tax rate on the total price of a new home would be somewhat lower.

The GST would impose a 9% tax rate on the retail price of a new house purchased from a developer, or of a substantially renovated house. This would include the land on which the house was built as well as the value added which went into the construction of the house. Thus the GST has the potential to increase the price of new houses substantially.

To offset this impact, the government is proposing to rebate up to one-half the GST otherwise owing, subject to restrictions on the price of the house. For houses costing no more than $310,000, one-half of the tax would be rebated. The maximum rebate of $13,950 would also be offered for houses priced up to $350,000. (At this point only four percentage points of the tax would be rebated.) Beyond that price, the rebate would decline so that none would be offered for houses priced at $400,000 or more.

Clearly, the tax implications of the shift to a GST would vary across Canada since house prices vary greatly. As the technical paper notes, homebuyers in Toronto would face the greatest adverse effect of this change.

Individuals could reduce the effective GST paid by purchasing land separately and contracting to have a house built. Land purchased from non-registered traders would not be subject to tax and dividing the total housing cost between land and structure could entitle a homebuyer to a rebate when the total cost might push the transaction over the limit for the GST rebate.

Consider two examples. In the first,a homebuyer could purchase a $250,000 house from a developer, on which a $22,500 GST would be nominally charged. Half would be rebated so the effective GST paid would be $11,250. If the purchaser bought the land from a non-registered trader and contracted for a house to be built, he would pay no tax on the land. Assuming that 25% of the total cost constitutes land cost, this individual would pay $62,500 for the land and construct a $187,500 house, on which total tax paid after rebate would be $8,437.50. If the homebuyer purchased the land from a registered trader, he would have to pay GST on the land and

include that amount with the price of the house when claiming a rebate. The total rebate would then be $11,250, whether he bought from a developer or not.

Now consider the case of a homebuyer wishing to purchase a $400,000 home. If he purchased it from a developer, he would pay $36,000 in GST and receive no rebate. If he purchased a $100,000 plot of land and built a $300,000 house on it, he could save a substantial amount of tax. If the land was bought from a non-registered trader, it would not be taxed at all, while the tax on the house would be $13,500 after rebate. The total GST saving would be $22,500. Even if the land purchase was taxable the buyer could save on GST if the dwelling cost alone were applied to the rebate cutoff level. By reporting only the $300,000 cost the buyer would get a rebate of $13,500 on the dwelling. Adding the $9,000 full GST paid on the land would give a total GST bill of $22,500, as opposed to the $36,000 paid when buying from a developer.

The rebate scheme is designed to exclude wealthier families from its benefits. Housing expenditures are directly related to income and normally the rebate would be based on either variable. Exceptional housing markets such as those in Vancouver and southern Ontario would create anomalies, however. The government's proposed use of housing expenditures, rather than income, to determine the rebate, means that the rebate could be delivered at the time of purchase, rather than after tax forms had been filed. The size of rebate would be substantial and any lengthy delay could be costly to purchasers.

Newly-constructed houses would have to compete with the existing stock of houses, which would not be subject to tax upon resale, except in certain circumstances. Buyers see the two as relatively close substitutes; the total price they are willing to pay for each type of housing is the same. The fact that one component faced a tax while the other did not would be irrelevant to them. The relative prices of new and old housing should remain fairly stable with the imposition of a tax on new housing.

Consider a housing market with a taxed and untaxed sector. Applying the GST to one sector would drive up its prices, reducing the quantity demanded and increasing the price difference between the two

sectors. Since the two types of housing are substitutes, this increase in relative prices would cause some housing demand to shift from the taxed sector to the untaxed sector. But an increased demand for untaxed housing could not bring forth any increase in supply since all new housing is, by definition taxed. Therefore the prices of old houses would have to rise. The GST would also cause new house construction to decline and thus raise new house prices also.

In the future, the stock of untaxed housing would decline as older homes were destroyed or renovated. Population and income growth and demographic change would increase the demand for housing, yet any net addition to the housing stock would have to come from the taxed (new) sector. This would be the marginal supply at which the price would be determined. The imposition of the GST on new housing would, then, raise house prices and confer a windfall profit on owners of existing housing.

B. Rental Accommodation

In 1991 or later, all aspects of the construction of a building would be subject to the GST, as would the cost of the land. (Long-term residential rentals would be exempt from the GST. No tax would be collected on these rents and the landlord could not claim an input tax credit on any GST paid.) The tenant of new accommodation would then pay a rent which effectively included a GST component for all of the value added going into the accommodation, except for this last stage. Newspaper reports indicate that rent review authorities would consider the GST paid as legitimate expenses in the determination of rents. Any subsequent sale of this building would then also be exempt from GST.

Buildings constructed prior to 1991 were never subject to a GST, although they were subject to the MST in existence at the time of construction. Longterm residential rentals from these would also be exempt from GST.

Commercial and short-term residential rentals would be subject to the GST, for which landlords would be eligible for a full input credit. Subsequent sales of these buildings would be subject to the tax.

Where a building provided taxable and tax exempt rentals, prorating would determine the extent of input credits allowed. Whether a building provided taxable or tax-exempt services, no rebate would be made available; the full 9% GST would be paid upon construction.

Again, the obvious question is the possible impact of the proposed tax on the price of rental accommodation. Tax exempt status means that rentals in new buildings would be subject to some tax, although this tax component would be hidden from the consumer and would effectively be less than 9%. Such a tax would not apply to residential rents in older buildings. From the point of view of the consumer, the relative demand for the two types of rental accommodation would not change and therefore the relative prices should stay about the same.

The introduction of a new and larger tax on new construction should raise rents across the board. To see how this would work, consider a case where the market was in equilibrium. A stock of older rental accommodation would exist against which some level of demand applied. This would set a market price. The alternative market would consist of new rental accommodation. In this sector a market price would also be established according to supply and demand. If a tax was introduced in the new sector, the price there would rise and the quantity demanded would fall. As the tax drove up the price of new apartments, some demand would shift to old apartments. But an increased demand for older apartments could not increase the fixed supply, so the consequence would be fully reflected in price hikes in that market also.

Rent controls complicate this picture but do not alter the fact that excess demand would exist in this sector. If it could not be eliminated via price increases, other adjustments would take place.

In any event, it is clear that developments in the taxed sector would also affect the non-taxed sector. Prices would rise in both segments of the market and the amount of new construction should decline.

C. Land

Personal use property would not be subject to the GST upon resale. This would include any land sold by a non-registered trader. Such a transaction would not be subject to tax even if the purchaser was someone who engaged in activities which were normally subject to tax. If a real estate developer bought land from a non-registered trader and developed it for resale, the original sale would not generate GST liabilities and no input credit could be claimed. In the end, however, the land would be taxed, like all other inputs going into the real estate development. If this development consisted of units eligible for the rebate, the purchaser might pay as little as 4.5% tax. When an individual contracted to have a house built, the same rebate would be available.

An individual would be able to save tax by purchasing land from a non-registered trader who held land for personal use. In this case, the purchaser would not pay GST on the land and would pay only on the building.

D. Renovations

A homeowner who repaired or renovated his home would pay GST on the cost of those repairs or renovations, in the same way as an individual would pay GST when buying a haircut or a suit of clothes or a car. Such renovations and repairs would not affect the tax status of the house when it was re-sold; it would still be exempt. Houses which were substantially renovated by an individual or firm normally in the business of making such renovations would be treated like a new house and be subject to GST upon resale.

WHO WOULD PAY THE TAX?

The GST is generally seen as a tax which would be borne by the final consumers of goods and services, if these were consumed in

Canada. Intermediate stages of production and distribution would be subject to tax on sales but these stages would also be eligible for a full input tax credit. Thus only value added would be taxed at each stage. If the tax liability at each stage was passed forward, the final consumer would ultimately bear the full burden of the tax.

Economic literature has long examined the issue of "tax incidence" which attempts to determine who bears the burden of taxation. While tax design can affect it, such incidence is largely a matter of market conditions. Tax incidence tends not to be something which can be legislated. Thus, for example, the legal responsibility to remit the tax can be placed on either the seller or buyer but may not influence who actually bears the cost.

Being able to determine the incidence of the tax gives some clues as to the taxpayer's attitudes to it. If a taxpayer could pass the tax on fully, he would be indifferent to being taxed at 9%, being taxed at 0% or being tax exempt. Since taxpayers do express a preference, it is likely that they must consider that they bear some of the burden themselves.

A sales tax is usually borne by both sellers and buyers, but to what degree depends upon the characteristics of both supply and demand. In some extreme cases, the burden of the tax is borne solely by one side.

Canada is a small, open economy and as a result many products can be purchased in unlimited amounts at the world price. In these cases, with imports setting the domestic price, the introduction of a sales tax on both domestic and imported products will always be borne fully by consumers. If for some reason the tax does not apply to imports, then domestic producers bear the full brunt.

Some imported services might well be impossible to tax. Examples are financial services such as insurance, stock broking, banking, etc. on which a Canadian, by contract with an off-shore firm, could completely avoid paying the GST. In such a case the domestic producers of the same service would bear the full burden of any GST.

A trader selling in the retail market and not able to pass on any tax, would always prefer zero rating to exemption, unless compliance costs were particularly onerous. That trader would also prefer exempt

status to being taxed at the full GST rate. If, however, the trader did not deal at the retail level, he might well prefer being subject to a 9% GST rather than being exempt. In the former case, customers could receive a full credit for input taxes paid whereas in the latter case they could not. A seller subject to extraordinarily high compliance costs might prefer tax exempt status, but in most cases a trader not dealing at the retail level would be better off being subject to the full tax.

HOW OFTEN WOULD THE TAX BE CHARGED?

A. Used Goods

The GST is a value-added tax rather than a sales tax. A sales tax can be thought of as a tax on a transaction rather than a tax on a product. Thus a provincial sales tax might be applied to a product numerous times: think of an automobile which is sold new, and taxed, and later resold through a dealer and taxed again. This kind of multiple taxation should not occur with a GST type of value-added tax.

Why then would used products be taxed under the GST? There are several reasons. Used goods compete with new products and are often sold by the same retailer. If one was taxed and not the other, compliance costs for the seller might increase and an opportunity for tax evasion might present itself. Taxing one and not the other might also distort the relative prices of the two types of goods, especially if an untaxed source of used goods, say through imports, was available. As well, the sale of used goods often involves the creation of some value added. By taxing this sale, that value added can be effectively taxed. The real issue, though, is whether or not the taxation of used goods would cause any tax "cascading" and thus increase the effective tax rate to more than 9%.

Used goods sold by non-registered traders would not be subject to the GST, while the same goods sold by a trader would be taxable. Would this create a distortion or non-neutrality? The answer is no, even though the used car industry is worried about a potential bias against it.

When a dealer bought a car from a non-registered trader, he would be able to claim a notional input credit as if he paid GST on the transaction, even though no tax was actually paid. Thus the effective cost of the car to the dealer would be less than the actual price paid. He would then add his markup and charges tax on the sale. The dealer's total selling price, including tax, would be little different from what it would have been before the tax.

Consider the following example. A used car could be sold by an individual to another individual or to a dealer for $10,000. The introduction of the GST would not affect the sale between two individuals. If a dealer bought the car he could resell it for $11,000. If, under GST, the dealer bought the car for $10,000, he could claim a credit of $826, i.e.,9/109ths of the purchase price, even though he paid no tax. The effective cost to him would be $9,174. To this he would add his $1,000 markup for profit, inspection, repairs etc. to give a selling price of $10,174. Add to this the 9% GST, and a purchaser would end up paying slightly more than he would have paid in the absence of this tax, i.e., $11,089.66 as against $11,000. The difference is simply the tax applied to the dealer's value added. No distortion would be created between private sales of used goods and sales through registered traders and no tax cascading would occur.

B. Appreciating Used Goods

There is an exception to this general rule: the class of property called "appreciating used goods" in the technical paper. This category includes personal property such as prints, etchings, paintings and sculptures, jewellery, stamps and coins. No notional credit would be allowed on these goods when bought by a registrant from a non-registrant. The notional credit is designed to remove any tax inherent in the purchase price of a good, when bought from a non-registrant. When goods appreciated in price, however, such a notional credit would offset more tax than was actually embodied in the good.

With appreciating used goods, a notional credit would likely lead to situations in which the government's tax take was less than 9% of

total value added, even though that was the nominal rate applied to sales. This is because the notional credit based on purchase price could over compensate for GST previously paid. If no notional credit was granted, tax cascading would occur and the effective tax rate could exceed 9%.

There are at least two issues here. The first concerns government revenues and the second concerns the distorting impact this tax might have on traders in these types of used goods.

Most goods in this category do not appreciate over time; this is particularly true of works of art. A notional credit on an appreciating product would reduce government tax take only when the good passed from a trader to an individual and back to a trader: sales between registered traders would be taxable and creditable. Furthermore, the government tax take would be reduced only when the individual sold the good to a trader for more than he originally paid. Since trader markups are very high in these products, such appreciation would be rare. Indeed, such rapid price rises are usually found only in times of high inflation. Thus the use of notional credits for such goods would cost the government little in the way of lost taxes.

By denying traders access to notional credits in these goods, the government would be penalizing registered traders by effectively taxing their value added at more than 9% in some circumstances. This is the type of situation that used car dealers erroneously thought would apply to them. It would, however, apply to antique dealers, coin and stamp dealers and art galleries.

EXEMPTIONS AND TAX FREE GOODS

Preferential tax treatment would be accorded to two groups of goods and services. Some, such as basic groceries, prescription drugs and medical devices, would be free of tax. This would be achieved by charging a zero-rate of tax on retail sales and allowing all traders dealing in these products to claim full credit for any taxes paid on inputs. In this way the final selling price would contain no tax at all; the intent is clearly to reduce the relative price of these goods.

This rule would also apply to all exported goods and services. In this case, however, the intent is not so much to grant a preference to foreign consumers as it is to recognize that Canadian exporters cannot charge more than the international price and that any tax would be, therefore, borne by exporters. The tax free status of exports is designed to enhance the competitiveness of Canadian exports.

Another category of goods and services which would receive preferential treatment are tax exempt supplies. The sale of such products would not generate a tax liability but traders would not be able to claim any input credit for taxes paid on inputs. Products included in this category are long-term rentals, day-care services, certain supplies by charities, non-profit organizations and government organizations. The savings to the final consumer would depend upon the proportion of total value added produced by the seller of the tax exempt supply. The only thing that can be said conclusively is that the consumer would not see the tax that he paid.

Where the tax exempt product was relatively labour intensive, such as a daycare facility, the tax exemption would be relatively beneficial to the consumer. Where the supplier's contribution to total value added was relatively small, the tax saving to the consumer would be small.

Exempt goods break the chain of value added taxation. If an exempt supplier sold at the retail level, or if an exempt product was sold at a retail level, this would create no tax cascading. It might pose a problem for an intermediate seller, however.

Recall that an exempt sale would be one in which no GST was charged but for which no input credit was allowed to the seller. The product would therefore contain some hidden tax. If the purchaser of this product used it as an input into the production of non-exempt products, he could not claim an input tax credit, though tax would be applied to his final sales at the appropriate rate. Those products taxed at 9% might have an effective tax higher than this amount while tax free goods might have some positive effective tax rate. Thus tax exemptions at the intermediate level might generate some amount of tax cascading.

Exempt status would free the trader from the paper burden associated with the tax. In instances where this burden might be onerous, exemption would be useful. This is why a blanket exemption would be offered to traders whose sales were less than $30,000 per year.

ADMINISTRATIVE AND COMPLIANCE ISSUES

A. Complexity

Other than attributing $200 million for added administration costs, the technical paper has remarkably little to say about the twin issues of administration and compliance costs; yet these costs are vitally important to the design of a tax system. Indeed, many of the design issues still open to debate are driven by just such considerations.

As proposed in the technical paper, the GST would include goods taxed at 9%, goods taxed at 0%, tax exempt goods, and tax exempt suppliers. Any registered trader would incur compliance costs, and the more complicated the system, the higher these costs. If all goods were taxed at the same rate, tax liabilities could be calculated very simply: tax liabilities would equal total domestic sales less total purchases, multiplied by 9%. If the amount was positive, the firm would have to send a cheque; if it was negative the firm would claim a refund. There would be no need to exempt small traders since they would bear no extraordinary compliance costs. All firms would keep the same kind of records as they now keep and these would be available for audit. Because small businesses would not need to be compensated for collecting the tax, an estimated $600 million would be saved.

The complexity of compliance increases dramatically as we move away from this simple system. According to the International Monetary Fund, a system with one positive rate, a zero rate and exempt products requires nine pieces of information from each taxpayer. A system like that in Ireland, with two different positive rates, in addition to a zero rate and tax exempt goods, requires 38 pieces of information.

The same is true of administration costs. A simple system is less costly to administer and audit. The MST is currently plagued by thousands of special rulings and administrative orders, approximately one for every three registered taxpayers. These are the result of appeals by traders. The tax authorities must evaluate such appeals, draft rulings, interpret them and apply them. The GST is expected to have 1.25 million taxpayers (those who remit payments to the government) and, as presented in the technical paper, looks as it would also be fertile ground for such special cases.

There are large fixed costs associated with administering a sales tax. Generally, the higher the rate, the lower are average administration costs when expressed as a percentage of tax revenue. Average costs also decline as the system is simplified. It is likely, however, that these costs do not decline continually with increasing rates. Very high rates promote tax avoidance and evasion thereby increasing enforcement and auditing costs. The international evidence suggests that it is not unreasonable to expect total administration costs to be about 1% of total revenues. The MST currently has administration costs of about 0.45% to 0.62% of revenues.

In addition to the costs incurred by the government, the GST would impose compliance costs, which in aggregate, tend to be several times as high as the costs to the government. A study of the United Kingdom VAT in the 1970s indicated that the business sector spent four times as much complying with the tax as it cost the government to run it.

The real concern with compliance costs, though, is their pattern with respect to firm size. It would cost far more for small business to comply with such a tax than it would cost larger firms. For the smallest firms, costs could exceed 1% of total sales. With a 9% GST rate, this compliance cost would amount to 11% of tax revenues. This is far higher than the administration fee offered by the government at a rate of 0.4% of revenues. At issue then is the degree to which streamlined accounting and reporting could lower small business compliance costs. The technical paper does offer an exemption to small traders but international evidence suggests that many traders do not make use of this option and that many of the estimated 750,000 small traders might prefer to register under the new system.

Most important, though, total compliance costs in Canada might be particularly high because of the very real possibility that traders would have to cope with two different sales tax systems, the GST and provincial retail taxes. The bases of taxation would be different as would the rates. Provincial taxes tend to be subject to minimum transactions levels; this would not be the case with the GST, according to the technical paper. Levying two such taxes at the retail level could generate compliance costs which exceeded the sum of costs for each tax.

B. Options

A seller dealing with products in more than one class would find it particularly difficult and complex to comply with the GST. Since determining the tax status of sales and inputs would create much confusion and expense for the private sector and the tax authorities, we must ask if options exist.

The obvious option would be to tax all goods at the same rate if at all possible. It is generally conceded that exports <u>cannot</u> be taxed, but basic groceries, drugs, and medical devices could be. Even though these goods are referred to as "meritorious," alternative ways of removing the tax burden exist. In the case of food, the refundable GST credit could be appropriately redesigned to favour low-income families, who spend a large portion of their incomes on food.

Another possibility might be to remove the tax from all forms of food. Recall that the GST, as outlined in the technical paper, would give preferential treatment only to food purchased for ultimate preparation and consumption at home. This distinction between kinds of food would create much of the administrative complexity at the retail level and administrative headaches for the tax authorities. All or nothing taxation might be better than the "mixed bag" proposed in the technical paper. The loss in revenues to the government from zero rating all food would amount to less than one percentage point of tax.

Sales taxes paid on drugs and medical devices could be rebated through the personal income tax (PIT) system. The PIT now contains

a non-refundable credit for such expenses which could also be redesigned and made refundable. It would then be easy to determine which approach possessed higher administrative and compliance costs.

FINANCIAL SECTOR TAXATION

To make a multi-stage sales tax as neutral as possible, it should be broadly based; thus there would be no reason to exempt financial services from this tax. Indeed, the federal government initially intended to do just that, by applying the tax to the margins of financial intermediaries. Virtually every country which levies value-added taxes has, however, chosen to exempt the financial sector simply because it is so difficult to tax efficiently. Canada now intends to follow this pattern. Moreover, because other countries have decided not to subject this sector to a VAT, and because of the nature of the product, the competitiveness of the Canadian industry could be harmed significantly if GST were imposed on it.

The technical paper defines a financial service as the exchange of currency, the lending or borrowing of money, underwriting and the transfer of ownership of financial instruments. Dealings in financial instruments are financial services. These transactions would be tax exempt.

According to the technical paper, leasing would not be considered a financial service, all lease payments would be subject to the GST. This is in contrast to the treatment of long-term residential rents which would be tax exempt, though they represent nothing more than the long-term leasing of real property.

Leasing is an alternative to direct borrowing for the purpose of purchasing a long-lived asset. With direct purchase of an asset, tax would be applied to that transaction but would not be applied to the interest associated with the loan. Interest payments constitute a very large proportion of monthly payments, and they would not be taxed. Leasing is essentially the same activity, all packaged together. Subjecting the entire lease payment to GST would subject one financial service, the

borrowing of money, to taxation. As a result, at the retail level, leasing might no longer be a competitive alternative to traditional financing.

CONCLUSION

The intent of the Goods and Services Tax is to provide the federal government with an efficient alternative to the existing Manufacturers' Sales Tax. Efficiency would be achieved by taxing a fairly broad base, thereby minimizing distortions in consumer choice. By crediting the tax paid on business inputs, the GST is also intended to remove tax from capital and thus enhance productivity. Such a tax should also enhance the competitiveness of the Canadian economy by removing the tax from exported products and treating imports and domestic production equally. In both of these ways, the existing tax fails the efficiency test.

No tax is perfect and GST is no exception to that rule. The discussion above has pointed out some of the "weaknesses" inherent in the present proposals. Where the tax is likely to be particularly suspect is with respect to administration and compliance costs, the area where very little detailed information is currently available. It is these issues, however, which might ultimately determine the success or failure of this reform.

FIGURE 1
GST CREDITS
THREE FAMILY CONFIGURATIONS

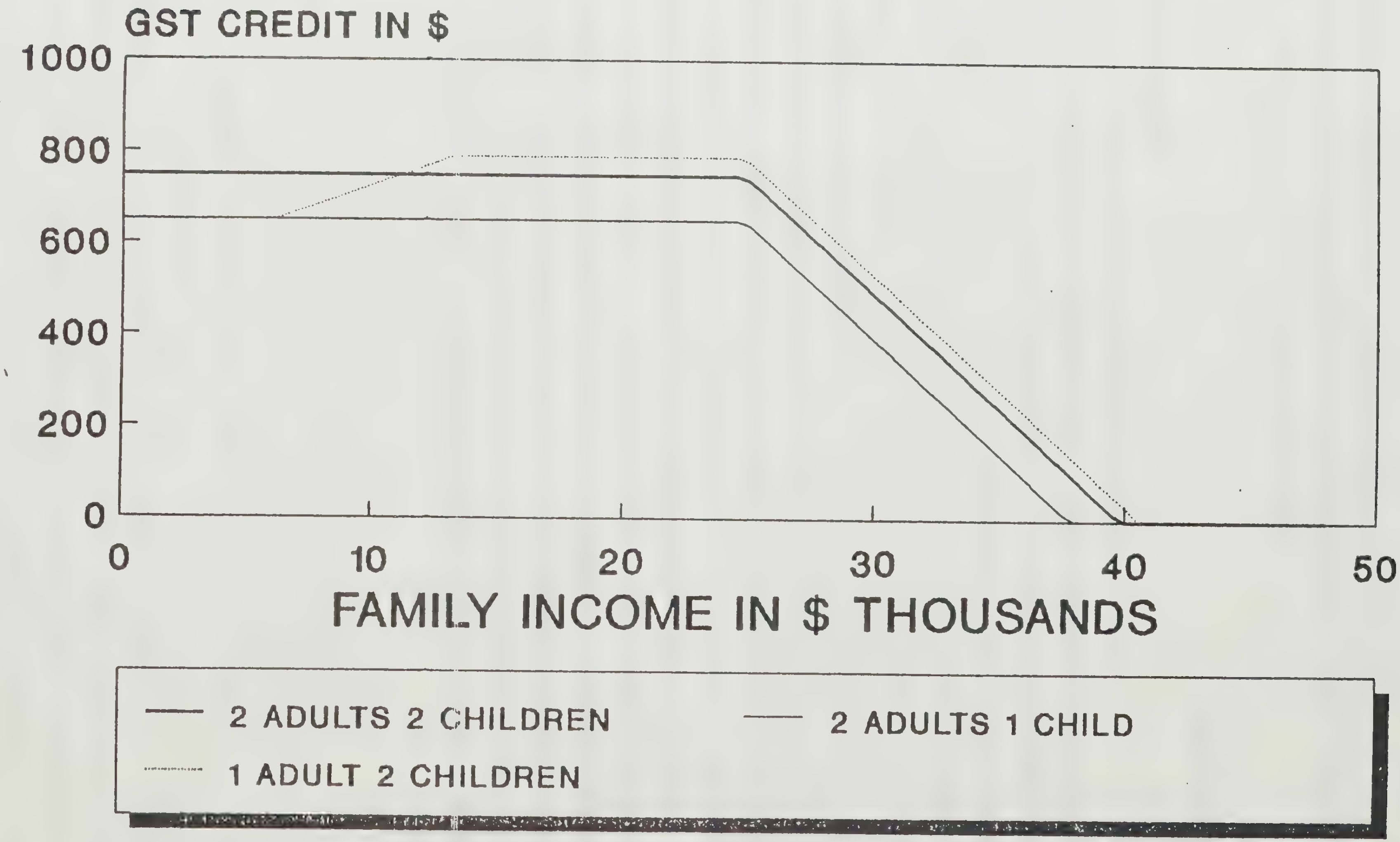

FIGURE 2
GST CREDITS: TWO ADULTS NO CHILDREN
MARRIED VS UNMARRIED

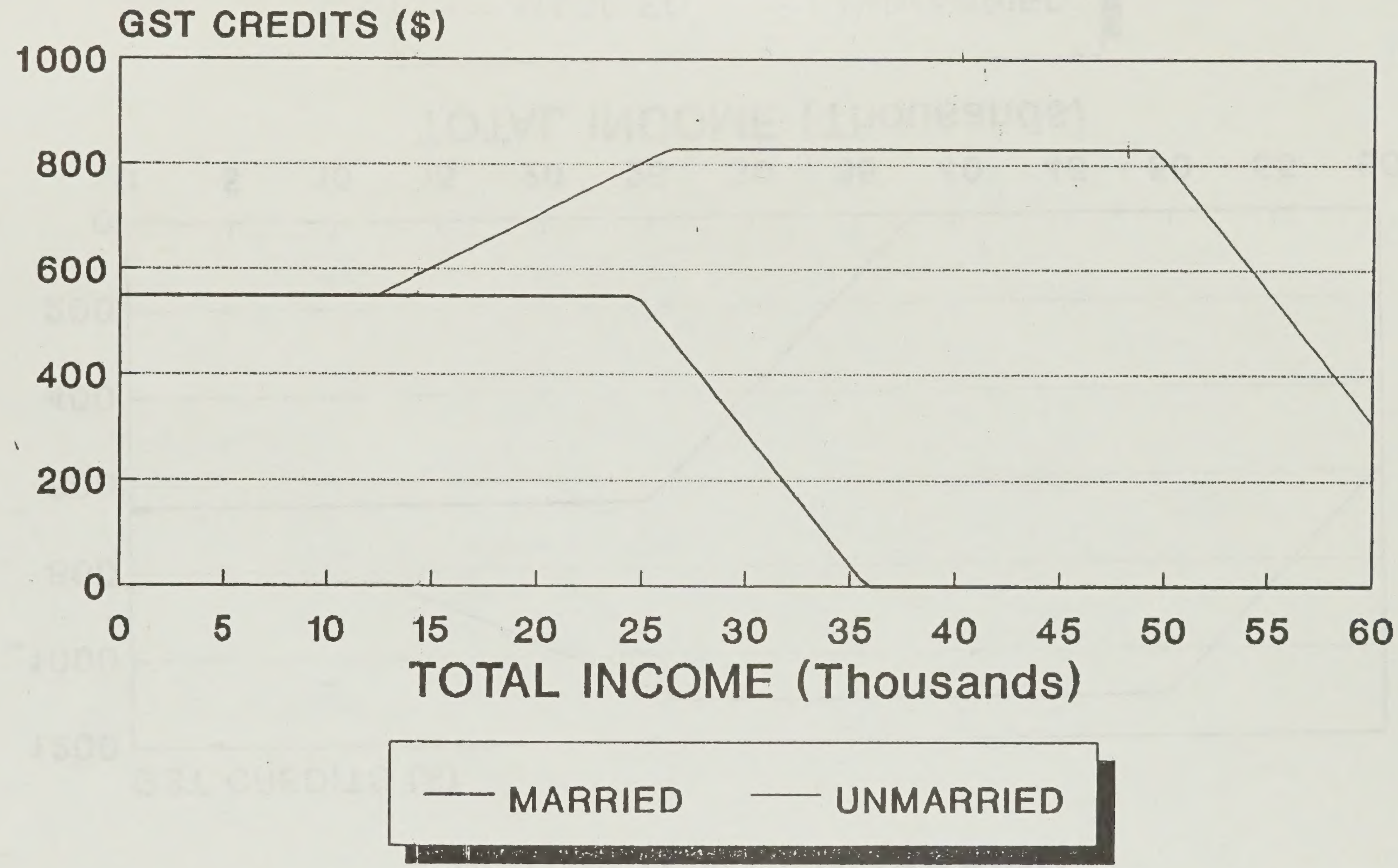

FIGURE 3
GST CREDITS: TWO ADULTS ONE CHILD MARRIED VS UNMARRIED